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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 267

SOUTHWEST NATURAL GAS COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and the opinion of the Tax Court (R. 26-41) are reported at 14 T.C. 81. The opinion of the Court of Appeals (R. 70-74), and the dissenting opinion (R. 74-77) are reported at 189 F. 2d 332.

JURISDICTION

The judgment of the Court of Appeals was entered on May 30, 1951. (R. 78.) The petition for a writ of certiorari was filed on August 22, 1951.

The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

The taxpayer corporation acquired all the assets of another corporation pursuant to a statutory merger in which the stockholders of the merging corporation received almost the entire consideration in the form of cash and the taxpayer's bonds, with only a small portion of the consideration being represented by common stock of the taxpayer.

The question is whether the Tax Court and the court below correctly held that, since the stockholders of the merging corporation did not acquire a sufficient proprietary interest in the merged corporation, the transaction did not constitute a reorganization, as that term is used in the Internal Revenue Code, Section 112 (b) and (g).

STATUTE AND REGULATIONS INVOLVED

The applicable portions of the statute and regulations involved are set forth in the Appendix, *infra*.

STATEMENT

The pertinent, undisputed facts found by the Tax Court (R. 28-34) may be summarized as follows:

The taxpayer, a Delaware corporation, is an operating public utility engaged in the natural gas business. Prior to 1934, the taxpayer and Peoples Gas and Fuel Company, Inc. (which will

be referred to as Peoples) were subsidiaries of a common parent company. In 1935, however, the parent had distributed its stock holdings in these two corporations to its own stockholders. (R. 28.)

In December, 1940, pursuant to the laws of Delaware, a merger of the two corporations was effectuated, and all of the assets belonging to Peoples were transferred to the taxpayer. (R. 29.) Prior to the merger, the taxpayer's balance sheet showed assets in excess of $4,300,000, and liabilities which consisted of more than $1,000,000 of bonds, and certain other long term debts. It had an authorized capital stock of 20,000 shares of cumulative preferred stock, series A, of which 9,590 shares were outstanding in the hands of the public. This stock, which had a par value of $10, and was entitled to preferred dividends of $6, was in arrears in dividends in the amount of $12.75 per share. Its authorized capital stock also included 1,200,000 shares of common stock, of which 566,150 shares were issued and outstanding. The common stock, which had a par value of 10¢ per share, possessed a market value of 5¢ per share. (R. 30-31.)

Prior to the merger, the balance sheet of Peoples showed assets in excess of $1,600,000, and liabilities of approximately $95,000. Peoples had issued and outstanding approximately 18,000 shares of common stock which had a market value of $30 per share. Stockholders who owned approximately 85% of the common stock of the taxpayer owned

35% of the common stock of Peoples prior to the merger. (R. 30-31, 33.)

Pursuant to the agreement of merger, the holders of 7,690 shares of Peoples' stock exercised an option to receive $30 in cash for each share of stock. The remaining stockholders, owning 11,185 shares, exercised an alternative option pursuant to which they received bonds of the taxpayer having a total fair market value of $314,415, cash in the amount of $17,779.50 for fractional bond interests, and 111,850 shares of the taxpayer's common stock. The common stock, which had a total fair market value of $5,592, represented 16.4% of the taxpayer's common stock outstanding immediately after the merger. In connection with the merger, the taxpayer assumed liabilities of Peoples amounting to approximately $94,000. (R. 32-33.)

The issue before the Tax Court concerned the basis to be used by the taxpayer for depreciation of the assets which it had acquired from Peoples in the merger, and there was also involved the proper amount which should be included in the taxpayer's equity invested capital as property paid in for its stock. The parties had stipulated what these amounts should be, dependent on whether the merger of the corporations constituted "a reorganization within the meaning of the Internal Revenue Code." (R. 23-24.)

The Tax Court, in a decision reviewed by the whole court, held that the merger was not a reor-

ganization within the meaning of Section 112 (g) of the Internal Revenue Code. (R. 35-41.) The Court of Appeals, Judge Hutcheson dissenting, affirmed the decision of the Tax Court. (R. 70-77.)

ARGUMENT

1. The Court of Appeals, affirming the Tax Court, correctly held that the taxpayer did not acquire the assets of Peoples in a "statutory merger or consolidation" which could qualify as a "reorganization," as those terms are defined in Code Section 112 (g)(1)(A) (Appendix, *infra,* p. 14), and in which no gain or loss would have been realized by Peoples under Code Section 112 (b)(4) (Appendix, *infra,* p. 14).[1] The reason why the merger of these corporations was not a reorganization within the meaning of Code Section 112 (g)(1)(A) is that the stockholders of Peoples, who formerly possessed the complete proprietary interest in that corporation's assets, were divested (except in a most insubstantial degree) of that interest as a consequence of the merger, and they received compensation consisting almost entirely of cash and bonds for transferring their ownership. Since their interest was substantially and materially altered by the transaction, and since, after the

[1] If there was no reorganization, there is no dispute between the parties (R. 23-24, 34) concerning the ultimate tax problems, i.e., the proper basis of the acquired assets on which the taxpayer is entitled to depreciation, and the basis of the property which was paid in for the taxpayer's stock which is to be used in determining the amount of its invested capital for excess profits tax purposes.

merger, they no longer possessed the same kind of stake in the business venture which they formerly possessed, the requisite "continuity of interest" which is essential to a tax-free reorganization was lacking.

The doctrine that the stockholders in the old venture must be given a continuing, proprietary ownership of a substantial nature in the new before there can be a statutory reorganization (including statutory mergers or consolidations) in which taxable gain or loss will not be recognized, was developed in order to effectuate the Congressional purpose of limiting such tax-free exchanges to situations where there are only "changes in form and not in substance." H. Rep. No. 179, 68th Cong., 1st Sess., p. 16 (1939-1 Cum. Bull. (Part 2) 241). See also S. Rep. No. 398, 68th Cong., 1st Sess., p. 17 (1939-1 Cum. Bull. (Part 2) 266). The principle, particularly as it relates to corporate mergers or consolidations, is firmly established by the decisions of this Court which construed the statute as it stood prior to 1934. *Pinellas Ice Co.* v. *Commissioner,* 287 U.S. 462, 470; *Helvering* v. *Minnesota Tea Co.,* 296 U.S. 378, 385; *LeTulle* v. *Scofield,* 308 U.S. 415, 421. Cf. *Bazley* v. *Commissioner,* 331 U.S. 737.

While Section 112 (g)(1), Revenue Act of 1934, c. 277, 48 Stat. 680, made certain changes in the definition of the term "reorganization," including that relating to the merger or consolidation of corporations, changes which are now embodied in Sec-

tion 112 (g) of the Internal Revenue Code, there was no intent generally to abolish the continuity of interest principle which this Court had already announced as a requirement for all tax-free reorganizations. Nor did the amending language of the 1934 Act concerning statutory mergers or consolidations abolish or amend this doctrine as it specifically relates to reorganizations effectuated in that manner. Such was the express holding in *Roebling* v. *Commissioner,* 143 F. 2d 810 (C.A. 3d), certiorari denied, 323 U.S. 773, where the court rejected a contention, similar to that advanced by the taxpayer here, that under the amended statutory language the stockholders of the old corporation need not be given a substantial, proprietary interest in the continuing corporation as consideration for the corporate assets transferred in the merger.

The *Roebling* case, and the decision below which follows it, properly refused to accept this contention. The legislative history of the 1934 Act, far from evidencing a Congressional intent to depart from the fundamental concept of when taxable gain should be recognized on a corporate merger or consolidation, is consistent only with the conclusion that the same basic principles were to govern under the new language as under the old. Thus, the Committee Reports on the 1934 Act (H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12-15 (1939-1 Cum. Bull. (Part 2) 554, 563-565) ; S. Rep. No. 558, 73d Cong., 2d Sess., p. 17 (1939-1 Cum. Bull (Part 2) 586, 598-

599)) show that Congress was familiar with and gave its approval to the requirement that the old stockholders must continue to have a substantial proprietary interest in the new venture. Moreover, the legislature was motivated by a desire to prevent tax avoidance and to achieve nationwide uniformity in the application of the reorganization provisions. Since there is a wide variation in the requirements of state law relating to mergers and consolidations, and since many states do not expressly require that the stockholders of the merging or consolidating corporation receive any stock, or any particular amount of stock,[2] in the new or continuing corporation, Congress, consistent with its purpose of achieving uniformity, could not have displaced the continuity of interest requirement with one which would look merely to the varying provisions of local law, and could not have intended that there should be a non-recognition of gain for federal tax purposes where there was a substantial alteration in the interests of all concerned, as would be possible under the merger laws of some states, and as is true here under Delaware law.

Furthermore, all Treasury Regulations, ever since Treasury Regulations 86, Article 112 (g)-1, promulgated under the Revenue Act of 1934, have contained express provisions to the effect that there can be no reorganization, including statutory mergers or consolidations, under the taxing statutes in

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[2] See Fahey, *Tax Definition of Reorganization*, 39 Columbia L. Rev. 933, 950 (1939).

the absence of a continuity of interest on the part of the persons who were the previous owners of the enterprise.[3] The subsequent reenactment of the statute, and its amendment in other respects, with no indication of Congressional disapproval of this long, continued requirement of the Regulations, is fairly conclusive that since 1934, as before, a merger or consolidation will not result in a tax-free reorganization unless the stockholders receive a substantial proprietary stake in the new corporate business. *Commissioner* v. *Wheeler,* 324 U.S. 542, 547; *Douglas* v. *Commissioner,* 322 U.S. 275, 281-282; *Helvering* v. *Griffiths,* 318 U.S. 371, 395, 397.

2. *Helvering* v. *Minnesota Tea Co.,* 296 U.S. 378, 385, makes it plain that, in order for a transaction to qualify as a reorganization under the taxing statute, the continuing stock interest of the old stockholders "must be definite and material" and

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[3] The taxpayer attempts to create the impression that the Commissioner is being inconsistent in taking the position that the continuity of interest requirement applies to statutory mergers and consolidations under Code Section 112 (g) (1) (A), and refers to Mim. 4555, 1937-1 Cum. Bull. 244, for substantiation. (Pet. 10-11, Br. 21-22.) Actually, a fair reading of the mimeograph, particularly pages 250-251, 252, makes it clear that the continuity of interest requirement, generally applicable to all reorganizations, was stated to be the same after the 1934 amendment as it was before and there is complete harmony between Mim. 4555, the Treasury Regulations, and the Commissioner's position in this case.

In stating that *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, and the companion cases of *Nelson Co.* v. *Helvering*, 296 U.S. 374, and *Helvering* v. *Watts*, 296 U.S. 387, would not qualify as reorganizations under the amended language of the 1934 Act, the mimeograph was addressing itself to other statutory changes not having any connection with the general continuity of interest requirement.

it "must represent a substantial part of the value of the thing transferred." The receipt of bonds or other non-proprietary obligations of the reorganized corporation does not satisfy the statute. *LeTulle* v. *Scofield,* 308 U.S. 415; *Pinellas Ice Co.* v. *Commissioner,* 287 U.S. 462. Application of these standards to the present case confirms the conclusion of the lower courts that no reorganization took place. Prior to the merger, the stockholders of Peoples possessed the entire equity in that corporation's assets, undiluted by any substantial amount of corporate indebtedness. As a result of the merger, the stockholders of Peoples received $248,479 in cash, bonds having a fair market value of $314,415, and 111,850 shares of common stock in the taxpayer, possessing a total market value of only $5,592. The stock represented less than 1% of the assets acquired by the taxpayer. Mere recital of what the stockholders of Peoples received is sufficient to demonstrate that their stock interest after the merger did not "represent a substantial part of the value of the thing transferred." Instead, the cash and the cash equivalent which they received was so substantial, and the stock interest which they acquired was so relatively insubstantial, that it could not be concluded that the merger had brought about a mere change in the form of their ownership. On the contrary, since the merger resulted in the termination of their former interest as proprietors and their acquisition of a large

amount of cash and bonds, and only a meager stock interest, such a material change was brought about as to require the immediate recognition of income, to the extent realized, to all parties concerned, with an immediate readjustment in basis.

If the stockholders of Peoples had received only cash and bonds, the lack of continuity of interest and the failure to effectuate a tax-free reorganization would be too clear for dispute. The courts below quite properly refused to permit this conclusion to be altered by the fact that stock of an insubstantial value passed to the stockholders as additional consideration for the transfer of the corporate assets.

3. The point emphasized in the dissenting opinion below (R. 74-77), and on which the taxpayer places a great deal of reliance (Pet. 12-13, Br. 21-31), is that some of the former stockholders of Peoples who owned a minority stock interest (35%) in that corporation also owned the controlling, common stock interest (85%) in the taxpayer prior to the merger, and that their controlling interest in the taxpayer was increased (to 88%) after the merger (R. 31, 33). This, however, is a matter without significance, for it has never before been doubted that the assets of one corporation can be sold to another, even though there exists a common stock interest in both. The statute is concerned with what the stockholders of Peoples received as consideration for the transfer of that corporation's assets to the taxpayer; the

stock interest which they possessed in the transferee corporation prior to the merger has no bearing on what was done with their separate stock interest in the transferor corporation. As the *Minnesota Tea* case, *supra,* makes plain, the new stock interest which is received to evidence a continued proprietary interest in the transferred assets must represent a substantial portion of the value of those assets. Nothing can obscure the fact that here it was cash and a cash equivalent which was paid for the assets of Peoples received by the taxpayer, and that only a most insignificant amount of stock, in terms of value, was issued to acquire those assets.

4. There is no conflict in decisions and none is relied on by the taxpayer. The taxpayer's request that this Court reexamine the continuity of interest test (Pet. 11, 13-14, Br. 31) is without justification in view of the legislative history of the statute, the long continued Treasury Regulations, and the consistent decisions of this Court. No other reasons appear which would warrant further review of this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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SEPTEMBER, 1951.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges Solely in Kind.*—

* * * * *

(4) *Same.—Gain of Corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * *

(g) *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, * * *

* * * * *

(26 U.S.C. 1940 ed., Sec. 112.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.112(g)-1. *Purpose and Scope of Exception of Reorganization Exchanges.—Purpose:* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal

Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their under-

lying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

* * * * *

Sec. 29.112(g)-2. *Definition of Terms.*—The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112(g)(1). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange.

The words "statutory merger or consolidation" refer to a merger or a consolidation effected in pursuance of the corporation laws of the United States or a State or Territory or the District of Columbia.

* * * * *

The provisions of Sections 19.112(g)-1 and 19.112 (g)-2, Treasury Regulations 103, promulgated un-

der the Internal Revenue Code, are substantially the same as the corresponding provisions in Treasury Regulations 111, set forth above.

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